Financial Markets

Irving Trust

Irving Trust Company
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Economic Research & Planning Division

Friday (Noon)

March 27, 1981

Interest rates rose sharply this week as the markets reacted to the steadily tightening pattern in the Federal funds rate. After having traded a bit over 13% last Friday, the rate rose each day, averaging a bit under 15% on Wednesday and Thursday and slightly above 15% so far today. Rates on most money market instruments rose about 50-100 basis points, while long-term bonds sank several points in price.

As noted here several times in recent weeks, our view is that the Fed is doing what it said it would do some time back--i.e., pursuing a very cautious policy with regard to monetary expansion and resisting any rapid decline in interest rates. In practice, this policy periodically requires a deliberate effort to resist rate declines by providing less abundant reserves than otherwise would be called for. That appears to be what happened last Friday (March 20). Our projections indicated the need for a modest reserves injection on that day--which was not done. Moreover, Treasury deposits at the Fed were increased above the usual $3 billion target level--an action that reduces reserve availability. Consequently, there is a strong suspicion that the Fed was not comfortable with funds trading close to 13% and took measures (relatively covert but nonetheless effective) to push the rate higher. If this was the case, the effort was successful, as the funds rate for the statement week ended March 25 averaged 13.48%, and the average this week will be substantially higher.

At this point it is difficult to avoid a feeling of deja vu. The Fed similarly undersupplied reserves on Friday, February 20, with the result that late on the following Wednesday the funds rate hit 25% (this time late Wednesday funds only hit 18%). As a consequence, the funds rate moved higher on average for a couple of weeks before resuming its decline.

What seems to be happening is that the Fed's periodic defense of the lower bound of the acceptable range for the weekly average Fed funds rate creates a disproportionate reaction in the money markets for a period of time. If this interpretation is correct, then rates should remain highly volatile, prone to substantial backups, as the Fed slows their descent.

The Federal Open Market Committee meets March 31 against a background of unusually mixed economic indicators. Monetary aggregates (abstracting from M-1A) appear to be within their annual target ranges or perhaps slightly below in the case of M-1B. However, M-1B has been showing a rising trend, posting increases in five of the last six weeks. More to the point, with the economy recently showing greater strength than many had anticipated, the Fed staff may well be looking for some strengthening in money demand in the near term. However, the economy is beginning to show some signs of weakness--witness the small decline in the February index of leading indicators reported today, the second monthly drop in a row. In this setting, the Committee has ample reason to continue its cautious approach, and a downward drift in rates should continue to be marked by high volatility.

William C. Melton

Note: The full text of this letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

Irving Trust

Market Yields

	3/27/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	17.50%	17.50%	19.50%
Effective since	3/17/81		
Discount Rate at Federal Reserve Bank	13.00	13.00	13.00
Federal Funds	15.38	13.25	19.50
Repurchase Agreements	14.50	13.00	13.50
U.S. Treasury Issues			
Bills			
3 months	13.50	12.98	15.25
6 months	13.65	12.71	16.33
1 year	13.48	12.81	15.89
Coupons			
2 years	13.50	12.87	14.85
4 years	13.55	13.00	13.85
7 years	13.50	12.89	12.95
10 years	13.30	12.75	12.80
Long Bond	12.90	12.34	12.40
Negotiable Certificates of Deposit-Secondary Market			
1 month	14.00	13.10	17.25
3 months	14.15	13.20	18.15
6 months	14.15	13.25	18.45
1 year	14.50	13.50	17.25
Banker's Acceptances			
1 month	14.35	13.15	17.10
3 months	14.25	13.30	18.10
6 months	14.30	12.85	18.30
Eurodollar Deposits			
1 month	14.75	13.50	18.50
2 months	15.07	13.75	19.13
3 months	15.13	14.00	19.44
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	13.75	8.00	15.50
1 month	13.00	12.25	16.75
3 months	12.25	12.25	15.00
Bank Holding Companies			
1 month	13.75	12.50	16.50
Dealer Placed:			
3 months	11.00	12.00	17.25
New AA Corporate Utility Bond	15.50	14.60	14.25
Tax Exempt			
6 month Project Notes	6.85	6.40	8.75
1 year AAA Bond	7.00	6.80	8.00
5 year AAA Bond	7.75	7.40	8.10
20 year AAA Bond	9.50	9.00	9.10

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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